# Finance Commission's Role in Tackling State Fiscal Challenges

This editorial is based on **"Finance panel should curb populism"** which was published in The Hindu Business Line on 01/01/2024. The article argues that the 16th Finance Commission of India should give more weightage to fiscal efficiency and discipline in its devolution formula, and curb the populist tendencies of state governments.

**For Prelims:** 16th Finance Commission (FC), Old Pension Scheme (OPS), New Pension Scheme (NPS), Gross State Domestic Product (GSDP), Corruption Perception Index, 15th Finance Commission, Fiscal deficit

**For Mains:** Finance Commission, Need to Curb Populism in India, Finance Commission's role in Curbing Populism

The **16th Finance Commission (FC)** is about to be constituted for recommending the devolution of Central taxes and grants to States. The RBI's just published report: **"State Finances: A study of Budgets"** has red-flagged the issues the FC will certainly be asked to look into, like States reverting to the **Old Pension Scheme (OPS),** and unsustainable subsidies flowing from the guarantees or freebies promised at the time of elections, regardless of the financial conditions of States.

## The Constitution of Finance Commission

- The Finance Commission is a **constitutional body** that is established by the **President of India** under **Article 280** of the Indian Constitution.
- It consists of a **Chairman and four other members** who are **appointed by the President.**
- The Commission is responsible for making recommendations to the President on various matters related to the distribution of tax revenues between the Centre and the states, as well as the grants-in-aid of the states.
- The Commission is **constituted every five years or earlier**, as deemed necessary by the President.

## Why is there a Need to Curb Populism in India?

- **Fiscal Imbalance:**
    - **Rising Debt:** Between 2014 and 2022, the average **debt-to-GDP ratio of Indian states increased from 22.2% to 34.5%**, with populist states like Andhra Pradesh and Tamil Nadu witnessing steeper rises.
    - **Higher Deficit:** The combined fiscal deficit **of states reached 4.1% of GDP** in 2021-22, fueled by populist spending on free electricity, loan waivers, and social welfare schemes.

- **Revenue Shortfalls**: Tax revenues haven't kept pace with populist spending, with many states relying heavily on central government bailouts or borrowing to bridge the gap.

- **Economic Distortions:**
  - **Investment Decline:** Foreign Direct Investment (FDI) inflow into India declined by 10% in 2022, attributed by some to uncertainty created by populist policies like price controls and protectionist measures.
  - **Job Growth Stagnation:** Despite increased government spending, India's unemployment rate remained above 7% in 2023, indicating that populist policies haven't yielded significant job creation.
  - **Market Inefficiency:** Price controls in sectors like agriculture discourage production and lead to shortages, disrupting supply chains and impacting consumer welfare.
- **Erosion of Governance:**
  - **Increase in Corruption:** India's ranking on [Transparency International's Corruption Perception Index] dropped from 80 in 2014 to 85 in 2022, coinciding with the rise of populist rhetoric undermining institutional checks and balances.
  - **Declining Transparency**: The Public Affairs Index, which measures transparency in government decision-making, showed a downward trend in several states with strong populist leaders.

## What are Some of the Populist Policies taken by States which have aggravated the Debate?

- **Reversion to Old Pension Scheme (OPS):**
  - Some states in India have reverted to the OPS, abandoning the [New Pension Scheme (NPS)] introduced in 2004.
    - The OPS incurs indefinite liabilities towards employees' pensions, unlike the NPS, where the liability is limited to the employees' serving life.
  - An internal RBI study suggests that **OPS results in 4.5 times more liability compared to NPS,** with an additional burden of 0.9% of GDP by 2060.
    - This move is seen as retrogressive, restricting growth and compromising the interests of future generations.
- **Rising States' Fiscal Deficit:**
  - Many states have deficits due to subsidies for populist measures like free electricity.
  - States' average spending on subsidies is 0.87% of their [Gross State Domestic Product (GSDP)], with some states spending much more (e.g., Punjab 2.35%, Rajasthan 1.92%).

## How can the Finance Commission help Curb Populism?

- **Performance-Based Incentives:** The [15th FC's] proposal for **measurable performance-based incentives** is a step in the right direction. By linking financial transfers to States with specific outcomes, such as improved health, education, and agricultural indicators, the FC encourages responsible governance and discourages populist measures that may not contribute to long-term development.
  - Under **Article 280(3) of the Constitution,** apart from recommending the devolution of taxes and grants-in-aid to the States, the FC may be asked by the Centre to look into any other issue "in the interest of sound finance".
- **Objective Criteria for Populist Measures:** While the categorisation of schemes as populist and non-populist may be challenging, the FC can **work on developing objective criteria that take into account the diverse developmental needs of different States.**
  - This would require collaboration between the Centre and States to arrive at a consensus on what constitutes populist expenditure.
- **Fiscal Efficiency Parameters**: The FC can give **more weightage to fiscal efficiency** in its criteria for transfers. By emphasizing fiscal consolidation and measuring the tax effort of States, the FC can encourage responsible financial management. This can act as a deterrent to States resorting to populism without considering their fiscal capacity.
  - The 15th FC gave only 2.5% weightage to the fiscal efficiency as measured by tax effort (Own Tax to GSDP ratio). This could be reviewed by 16th FC.
- **Public Awareness:** The Finance Commission can play a role in creating public awareness about

the consequences of populist measures. By highlighting the strains on finances that **freebies** create and the long-term impact on economic growth, the FC can **contribute to informed public discourse, putting pressure on political parties to adopt responsible fiscal policies.**

- **Stress on Future Implications**: The FC can draw attention to the long-term consequences of populist measures, such as rising state debts and the burden passed on to future generations.
  - This could involve recommending measures that prevent States from borrowing beyond their capacity and ensuring that financial decisions align with sustainable development goals.
- **Consensus Building**: While consensus between the Centre and States on controlling populist expenditure may be challenging, the **FC can act as a mediator and facilitator in fostering dialogue.**
  - By promoting cooperative federalism and encouraging open discussions on fiscal matters, the FC can contribute to a more collaborative approach to financial governance.
- **Regular Review and Recommendations:** The FC can continually review the financial health of States and make periodic recommendations based on the evolving economic scenario. This allows for flexibility in addressing emerging challenges, including the impact of external factors such as the **Covid-19** pandemic.

## Conclusion

A state's populism should be funded by its own taxpayers, not others. The RBI suggests that fiscal transfers should be tied to reforms and fiscal responsibility. If a state chooses populism and borrows without funding, it should bear the consequences.

***Drishti Mains Question***

Discuss the role of the Finance Commission in curbing populism in India.

## UPSC Civil Services Examination Previous Year Question (PYQ)

### ***Prelims***

**Q. Consider the following actions by the Government: (2010)**

1. Cutting the tax rates
2. Increasing the government spending
3. Abolishing the subsidies in the context of economic recession,

**which of the above actions can be considered a part of the “fiscal stimulus” package?**

**(a)** 1 and 2 only
**(b)** 2 only
**(c)** 1 and 3 only
**(d)** 1, 2 and 3

**Ans: (a)**

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### ***Mains***

**Q.** In what way could the replacement of price subsidy with direct benefit Transfer (DBT) change the scenario of subsidies in India? Discuss. **(2015)**

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